STATE OF CALFORNIA
ELECTRICITY OVERSIGHT BOARD

Gray Davis, Governor

VIA ELECTRONIC MAIL

August 8, 2003

Mr. Tom Carter
Power Operations Manager
Western Area Power Administration
114 Parkshore Drive
Folsom, CA 95630-4427

Re: **Comments on Operational Alternatives for Implementing Western's 2005 Marketing Plan**

Dear Mr. Carter

Pursuant to the Notice of Intent published in the Federal Register,[1] the California Electricity Oversight Board ("CEOB") hereby comments on Western's proposed operational alternatives for implementing its 2005 Marketing Plan. The CEOB is a statutory organization of the State of California created to address issues arising from California's restructured electricity industry and markets. The CEOB works to ensure system reliability as well as just and reasonable wholesale electricity prices by providing oversight of the California Independent System Operator ("CAISO"), monitoring and investigating matters in wholesale energy markets that affect the public interest, and representing the State in legal proceedings that affect California's electricity system and markets.

**Summary of CEOB's Position**

The CEOB recognizes the validity of allowing California's load serving entities ("LSEs"), including many of Western's customers, to pursue operational and regulatory structures that they believe will best secure cost effective, stable, and reliable electrical energy consistent with their business models. The decisions of several relatively small LSEs, however, must be made in a manner consistent with the overall interests of California's electricity consumers and market participants. In this regard, the CEOB identifies three concerns with Western's proposal to create a new "federal" control area. These concerns are:

- The potential harm to grid reliability and operations from fragmentation of scheduling and control of major transmission paths (particularly the California-Oregon Intertie ("COI")).

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1 68 Fed. Reg. 37484 (June 24, 2003).

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- The likely shifting of costs properly borne by Western's customers to other California consumers.
- Adverse implications to market monitoring and enforcement against anti-competitive market behavior.

Unless Western is willing to adequately address these concerns, as discussed below, the CEOB strongly objects to the creation of a separate federal control area.

**Comments**

Western has identified three alternatives to replace its current arrangements for providing control area services that will terminate upon expiration of three long-term contracts on December 31, 2004.[2] Those alternatives are:

- Execute a Transmission Control Agreement with the CAISO and thereby become a CAISO Participating Transmission Owner.
- Execute a Metered Sub-System Agreement with the CAISO.
- Form a new "federal" control area.

The CEOB understands from comments at the Public Comment Forum, held July 30, 2003, that many of Western's customers prefer separation from the CAISO and therefore favor the formation of a new federal control area or similar combination with a non-CAISO control area. The commenters suggested this alternative better conforms to the elevated value they assign to cost stability (not minimization) and operational durability. The CEOB recognizes that our collective experience of 2000-2001 casts some doubt, whether warranted or not, on the prudence, viability and efficiency of centralized competitive electricity markets. The municipal utility and special utility district customers of Western largely demonstrated during the crisis their commitment to serving local customers and maintaining reliable service to the extent possible.[3] These local regulatory authorities should be allowed to pursue operational and regulatory structures that they believe will best secure cost effective, stable, and reliable electrical energy consistent with their business models and customer interests.

Nevertheless, as presently articulated, the CEOB believes that the creation of a separate federal control area potentially conflicts with the interests of the majority of California consumers. The CEOB's concerns implicate cost, operational reliability and efficiency, and market monitoring issues. Serious questions have been raised by the CAISO regarding the accuracy of Western's consultant's cost analysis. Western must address the CAISO's assertions. More important, Western's decision on how to replace the expiring long-term contracts also must

2 As described in Western's Notice of Intent, contract 2947A provides Western up to 400 MW of priority capacity on the Pacific AC Intertie. Contract 2948A integrates the generation and transmission of Pacific Gas & Electric ("PG&E") and Western. Contract 2949A interconnects PG&E's transmission system with Western at Round Mountain substation.

3 The CEOB notes, however, that allegations regarding the role of Western and certain of its customers in contributing to the crisis during 2000-2001 remain pending. See, e.g., *American Electric Power Service Corporation, et al.*, 103 FERC ¶ 61,345 (2003) ("Gaming Show Cause Proceeding") and *Enron Power Marketing, Inc., et al.* 103 FERC ¶ 61,346 (2003) ("Enron Partnership Show Cause Proceeding").

not impose on non-Western California consumers any undue burden in terms of cost and reliability impacts. Particularly, Western's final decision must provide an analysis of and account for the following:

1. Establish rates for Western customers that properly reflect the embedded costs of providing such services to those customers. In other words, Western must follow sound cost-causation principles by abandoning any plan to use the Malin to Round Mountain portion of the Pacific AC Intertie ("PACI") as a "toll both" to subsidize Western's preference customers merely to compensate for cost increases associated with expiration of 1967-era contracts.

2. Assign to a single entity the sole responsibility for all scheduling of transmission capacity, oversight of real-time operations and coordination of outages on the COI. Analyze the implications of this arrangement on the proposed federal control area prior to pursuing such option.

3. Take steps to prevent deterioration of grid reliability in areas, including, but not limited to, scheduling, path congestion mitigation, real-time path de-rates, loop flow management, disturbance recovery.

4. Develop provisions to minimize the potential for "phantom congestion" on PACI by creating recallable transmission rights or an equally effective equivalent.

5. To avoid seams issues, adopt scheduling and other protocols consistent with either the CAISO or BPA. Establish to the extent possible, identical rules for different classes of market participants using the PACI.

6. Coordinate outage management with the CAISO

7. Ensure effective market monitoring and transparency by providing the CAISO and state oversight agencies with access to requested data.

8. Determine more accurate cost estimates for the proposed alternatives.

9. Compensate the CAISO for any increase in its control area services costs resulting solely from the addition of the new federal control area.

If Western is unwilling to accommodate these concerns, the CEOB strongly objects to the creation of a separate federal control area. A preferable outcome would preserve the geographic scope of the present control area operations while protecting both Western and non-Western customers from cost increases and cost shifting. Under such circumstances, Western should select an alternative more consistent with the CAISO's proposed Metered Subsystem Agreement proposal.

<u>Cost and Cost Shifts</u>

Two aspects of the cost issue are relevant to the CEOB – whether Western's customers are fully informed as to the relative merits of the alternative proposals and whether non-Western customers will be burdened with additional costs. As to the first issue, the CEOB recognizes that Western's customers may freely choose to pay a premium to accomplish other business goals. This should be done, however, based on accurate information. The CAISO has identified significant purported errors and omissions in Western's cost report[4] that allegedly overstate the cost advantages of establishing a federal control area and understate the cost savings related to CAISO options. The CEOB need not detail each of these errors and omissions here.[5] It is sufficient to note that the CEOB finds the CAISO's analysis compelling and, if correct, demonstrates that alternatives other than the creation of a federal control area may save Western's customers between $10 to $30 million annually.

On the second issue, the CEOB understands that Western's proposal to create its own control area may shift costs both directly and indirectly to non-Western California consumers. Some cost shift from Western customers to other California ratepayers currently exists given that the cost to Western customers of control area and transmission services under the expiring contracts is less than the present embedded costs of such services. Such subsidizations should be avoided when possible and not perpetuated. The CEOB supports open, non-discriminatory access to the transmission grid where rates derive from cost causation principles. The CEOB understands that Western's 2005 Marketing Plan under the control area option, as proposed, violates these principles by imposing a wheeling charge on imports on Western's portion of PACI to subsidize Western's customers for their increased cost of transmission service. While the CEOB appreciates Western's efforts to provide least cost services, its cost recovery plan raises significant equity, efficiency and competition concerns. Generally, any rate charges that fail to reflect underlying costs restrict trade and can negatively impact the competitiveness and efficiency of the regional market. As such, the CEOB strongly urges Western to abandon this aspect of its plan.

An indirect cost shift follows from the increase in CAISO control area costs and inefficiencies because of the smaller geographic scope of the CAISO, increased complexity, and additional seams issues. Currently, the CAISO's Grid Management Charge ("GMC") uses total control area load to recover part of its revenue requirement. Without that load, more of the GMC will be charged to the remaining load. If the ISO's operating costs increase to deal with an additional control area, the CAISO's revenue requirement will also increase. In the 2004 GMC proposal, the CAISO shows a significant sum of the 2003 revenue requirement is allocated to Grid Reliability Services which goes towards control area services. Even without Western's load, most if not all of these costs will still exist. Western must compensate the CAISO for costs directly caused by any potential federal control area.

Reliability

Western's 230 kV and 500 kV transmission systems are critical components of Northern California's transmission grid. The power grid was built and has evolved in an integrated manner. The complexity associated with operating the Northern California grid as two systems

4 Navigant Consulting, *Analysis of Central Valley Project Operational Alternatives* (June 12, 2003).

5 The CAISO will no doubt include a cost analysis in their comments. A preliminary summary of the CAISO's analysis can be reviewed at http://www.caiso.com/docs/09003a6080/25/15/09003a608025150b.pdf.

raises reliability concerns related to scheduling, path congestion mitigation, real-time path de-rates, loop flow management, disturbance recovery and outage coordination. Yet, in its answers to questions poised at the July 9, 2003, Public Information Forum, Western admitted that it has not studied the complexities and costs associated with operating the system with a control area interposed between the CAISO and BPA.[6] Western asserts that if a decision is made to create a new control area, issues arising from the added complexity will need to be worked out as part of the WECC certification process. This is putting the proverbial cart before the horse. It seems irrational to approve a course of action not knowing whether one of the major criteria for selecting that option – operating transparency – supports or undermines the wisdom of the selection. Indeed, the CEOB has been told by BPA operators that the system cannot endure added complexity.

This added complexity raises heightened concerns with regard to operation of COI. Currently, the three COI lines are managed as a single coordinated operation. This arrangement must continue under any Western alternative. Western has stated that "the CAISO continue as the path operator for the COI, with full visibility for all the schedules and the ability to curtail schedules if reliability is threatened."[7] The CEOB agrees that having a single operator for COI is mandatory going forward. That entity should be given sole responsibility for all scheduling of transmission capacity, oversight of real-time operations and coordination of outages. Again, until the details of Western's proposal are fleshed out, its viability and overall impact on California remains unacceptably uncertain.

Market Monitoring and Enforcement

The FERC recently confirmed what many Californians long suspected - that fraud, manipulation and the exercise of market power contributed to the unprecedented wholesale prices experienced in 2000 and 2001.[8] The investigation into the crisis further illustrates that many of these anti-competitive schemes, such as "ricochet" and various congestion-related games, are extremely complex and can involve the explicit or tacit coordination of the assets of many market participants.[9] Vigilant market monitoring and enforcement is essential. However, as proposed, Western's creation of a separate control area impedes effective market oversight.

The increased complexity related to operating two separate control areas (i.e., the addition of potentially 15 new interconnection points), sharing operation of COI, and the potential for an additional layer of market rules, inherently increases the ability of market participants to

6 Western's Summarization of Questions/Answers July 9, 2003 Public Information Forum, pg. 4.

7 Notice of Intent, 68 FR at 37489.

8 E.g., *American Electric Power Service Corporation, et al.*, 103 FERC ¶ 61,345 (2003) ("Gaming Show Cause Proceeding") and *Enron Power Marketing, Inc., et al.* 103 FERC ¶ 61,346 (2003) ("Enron Partnership Show Cause Proceeding").

9 While the CEOB is aware that no final finding of culpability has been made in either the Gaming Show Cause Proceeding or the Enron Partnership Show Cause Proceeding, it cannot be ignored in the context of addressing the need for market monitoring that Western as well as Western customers are implicated in these proceedings.

engage in manipulative and anti-competitive behavior. This shortcoming is exacerbated by the reduction in transaction visibility. Information currently obtained by the CAISO regarding transactions over Western's transmission assets would no longer be available upon the disaggregation of the Northern California grid into separate control areas. The Western federal control area would create a "black hole." This is of major concern to the State. The CAISO has recently proposed to amend its tariff to enhance its market monitoring and enforcement authority, as well as increasing the access of other enforcement agencies to market data.[10] To maintain the efficacy of the proposed tariff amendment, Western must fully coordinate and cooperate with state oversight agencies and the CAISO's existing market monitoring staff either through a memorandum of understanding or other agreement that provides the CAISO and state agencies with complete access to relevant data.

**Conclusion**

For the reasons discussed above, the CEOB opposes Western's proposed creation of a new federal control area unless Western amends its control area alternative or otherwise adequately addresses each of CEOB's concerns.

Thank you for your conscientious attention to the CEOB's concerns.

Sincerely,

/s/

Erik N. Saltmarsh
Acting Executive Director

Cc: Hon. Secretary Spencer Abraham

10 *California Independent System Operator Corporation*, ER03-1102-000 (2003) ("Amendment No. 55").